

What Makes China Grow?

中国经济增长动力探源

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Lecture II

The Strategies of

Chinese Economic Development

Outline

- ◆ Introduction
- ◆ Economic Reform and Opening to the World
- ◆ Additional Economic Development Policies
- ◆ Economic Reform for the Future
- ◆ Concluding Remarks

Introduction

- ◆ In this lecture we deal with the economic strategies, policies and measures adopted and implemented by the Chinese Government during the past forty 40 years. These strategies, policies and measures include the “grandfathering” principle, the “dual-track” approach to the transition to a market economy, export promotion, maintenance of a stable exchange rate coupled with capital control, development of basic infrastructure and macroeconomic stabilisation. They have mostly proved to be successful, as evidenced by the sustained high average annual rate of economic growth of almost 10 percent% during the period.

Economic Reform and Opening to the World

- ◆ From 1953 to 1978, China was a completely centrally planned economy with mandatory sector-, industry-, enterprise-, village- and farm-household-specific production targets, and was essentially closed to the rest of the world, except for the former Soviet Union and the Eastern European socialist countries before the Sino-Soviet dispute around 1960.
- ◆ The economic reform in China which began in 1978 consisted of two major components—the introduction of free markets for goods in the Chinese economy (coupled with conditional autonomy for the producers, including the agricultural households) and the opening of the Chinese economy to international trade and inbound cross-border direct investment₅

Economic Reform and Opening to the World

- ◆ It is well known that there can be significant inefficiencies in centrally planned economies, with the economy operating well within the interior of its set of production possibilities—that is, far away from the frontier. As economic reform and opening proceeded successfully in China, the economy became progressively more efficient, and the point of operation of the economy began to move from the interior of the set of production possibilities to its frontier. During this process, the real output of the economy could be increased through increased efficiency alone without any increase in its inputs.
- ◆ Thus, with the introduction of enterprise and household autonomy, output could increase much faster than inputs. How much slack was actually there in the Chinese economy before its economic reform in 1978? Lau and Zheng (2017) have estimated that the real output of the Chinese economy as a whole in 1978 could have been 50 percent higher if it were operating efficiently.

Economic Reform and Opening to the World

- ◆ It was in Xiaogang Village, Anhui Province, that the “household contract responsibility system” in the Chinese agricultural sector was first introduced, spontaneously, in December 1978, setting in motion the agricultural economic reform in Anhui Province initially and then in the rest of China.
- ◆ The contract responsibility system basically divided up the responsibility of the commune to deliver fixed quantities of agricultural output and pay fixed amounts of taxes to the government among the individual households of the commune. As long as an individual household had delivered its quota of output and paid its share of taxes, it could produce whatever it wanted to produce, and sell any such additional output on the free markets, and retain all the proceeds for itself.
- ◆ The commune itself, which no longer had any production responsibilities, began to organise other productive activities, forming what were known as “Township and Village (T&V)” enterprises, producing whatever goods that were needed with resources available to the commune, and selling the outputs on the free markets.

Economic Reform and Opening to the World

- ◆ Under the “contract responsibility system”, the commune’s obligation to sell a fixed quantity of output at a fixed plan price and to pay a fixed amount of taxes to the government remained unchanged, so that the government was no worse off.
- ◆ The commune administration was also no worse off as individual households continued to be responsible for the deliveries of their allotted quotas of output deliveries and the payments of their pro-rata shares of the taxes to the commune.
- ◆ The households of the commune were also no worse off because after they fulfilled their same pre-existing obligations, they could do anything else they wanted to do and retain any income they managed to earn. They could also do nothing extra, but they would not be worse off. It was therefore a “reform without losers”, one that no one should or would oppose.

Economic Reform and Opening to the World

- ◆ The contract responsibility system was subsequently extended to the urban non-agricultural sector in a gradual manner beginning in the early 1980s, province by province. Shanghai was the last to implement the contract responsibility system in the non-agricultural sector, in 1992.
- ◆ Throughout this early reform period, the mandatory central plan continued to be enforced. The autonomy of the producers was conditional on first fulfilling their responsibilities under the mandatory central plan.
- ◆ Typically a non-agricultural enterprise would continue to receive its allotted inputs under the central plan at fixed plan prices and would continue to sell the assigned quota of outputs to the planned recipients, also at fixed plan prices. However, after fulfilling these obligations, the enterprise would be free to produce whatever it wanted to produce and bear any profit or loss therefrom.

Economic Reform and Opening: Transition from a Centrally Planned to a Market Economy

- ◆ This is referred to as the “dual-track” approach, that is, with the mandatory central plan continuing in force and the establishment of free markets coupled with producer autonomy in parallel. China did not adopt the “big bang” approach in its transition from a centrally planned economy to a market economy.
- ◆ Under the dual-track approach, every individual, collective and enterprise is free to participate in the free markets provided that it has fulfilled all its obligations under the mandatory central plan.
- ◆ One of the most important consequences of the “dual-track” approach is that no losers are created by the introduction of the free markets and producer autonomy, since everyone’s rights (and obligations) under the mandatory central plan continue to be enforced.

Economic Reform and Opening: Transition from a Centrally Planned to a Market Economy

- ◆ In fact, a distinguishing characteristic of Chinese economic reform is its emphasis on assuring that there are no losers. Indeed, “reform without losers” was what made Chinese economic reform so successful and the economic transition so smooth. It maximised public support and minimised opposition.
- ◆ In carrying out economic reform, China also frequently applied the “grandfathering principle”, that is, the principle of “new people, new way; old (existing) people, old way (新人新辦法，舊人舊辦法)”.

Economic Reform and Opening: Transition from a Centrally Planned to a Market Economy

- ◆ Moreover, as Lau, Qian and Roland (2000) have shown, the “dual-track” approach, with full enforcement of the pre-existing mandatory central plan, also results in full economic efficiency of the economy.
- ◆ As a result, China underwent a very smooth transition to a market economy, without experiencing any decline in GDP in either aggregate or per capita terms or hyper-inflation, as almost all of the former Soviet Union and formerly socialist Eastern European countries did.
- ◆ Eventually the value of the economic activities outside the mandatory central plan grew to be much bigger than those within the plan. The plan was then gradually phased out and became merely indicative and no longer mandatory (with the exception of environmental and poverty alleviation targets).

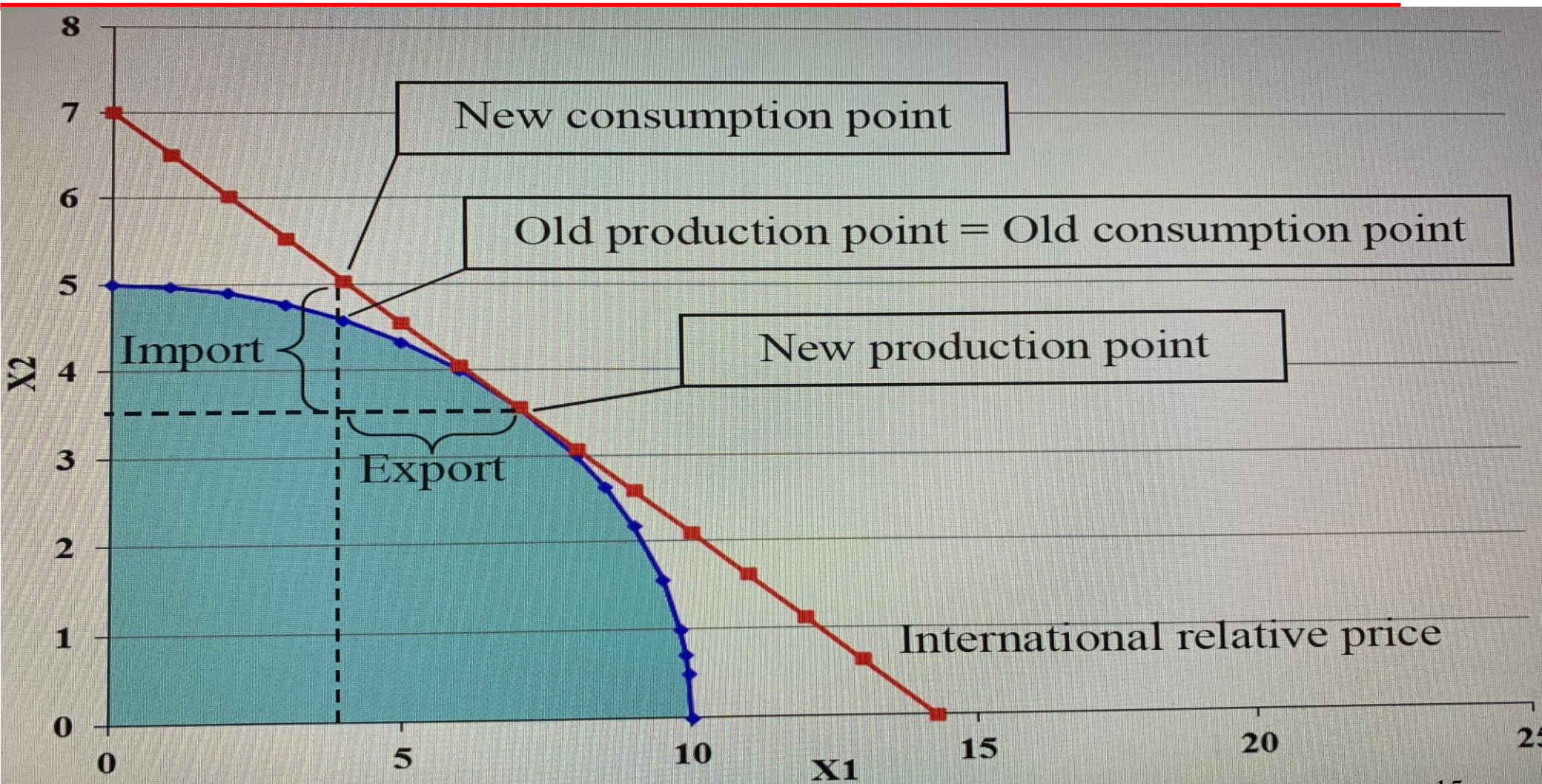
Economic Reform and Opening to the World

- ◆ The international trade embargo against China that began with the Korean War was continued even after the fighting ended with an armistice in 1953. There was little international trade between China and the rest of the world, with the exception of the essentially barter trade between China and the former Soviet Union and the formerly socialist Eastern European countries, which dwindled beginning in the 1960s because of the then Sino-Soviet dispute.
- ◆ However, with the secret visit of U.S. Secretary of State Henry Kissinger to China in July 1971, and the subsequent visit of U.S. President Richard Nixon in February 1972, international trade between China and the U.S. and other Western countries began to grow again.

Economic Reform and Opening to the World

- ◆ Machinery, equipment and raw materials which could not be produced in China at the time would be imported. In order to have the foreign exchange to pay for these imports, China would have to promote exports as well as inbound cross-border direct investment.
- ◆ Opening the economy to international trade always increases aggregate welfare of the economy, as the following chart illustrates. (However, even though the economy benefits in the aggregate, both winners and losers are created in the process.)

Opening the Economy Enhances Domestic Economic Welfare



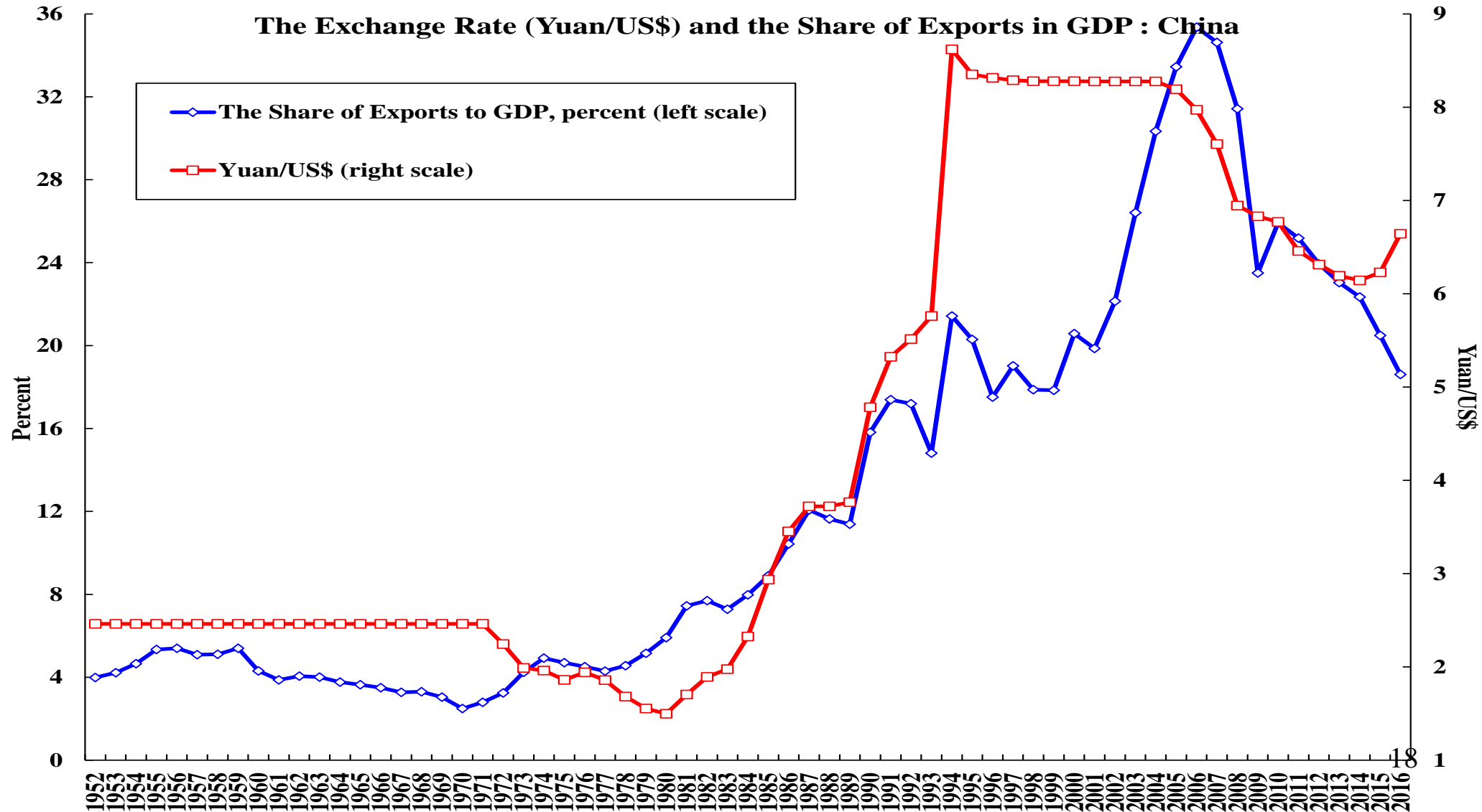
Economic Development Policies—The Opening of the Economy

- ◆ Japan, the East Asian “newly industrialised economies (NIEs)”, and Mainland China all had little natural resources. Capital equipment, oil, and raw materials such as cotton, all had to be imported. Thus, an open economy is essential for their industrialisation.
- ◆ To finance these imports in a sustainable manner, there must be exports, and exports to the world must follow the principles of comparative advantage. In the case of these economies, they would begin with specialisation in the production of labour-intensive light-manufactured goods.
- ◆ Opening the economy also attracted foreign direct investment (FDI) to augment domestic savings and facilitate technology transfer.

Economic Development Policies—The Promotion of Exports

- ◆ First Japan, and then Hong Kong, and then Taiwan successively and successfully adopted and implemented the economic development policy of export promotion. This was done through a significant devaluation of the respective currencies and the introduction of various direct and indirect incentives for exporters.
- ◆ However, import substitution, rather than export promotion, was the policy of choice of Western development economists in the 1950s. For example, India was advised to engage in import substitution as a strategy for its economic development. It proved to be a failed strategy.
- ◆ The growth of world trade has led the growth of world GDP for half a century, until the Global Financial Crisis of 2008.

The Nominal Exchange Rate and Exports as a Share of GDP: Mainland China



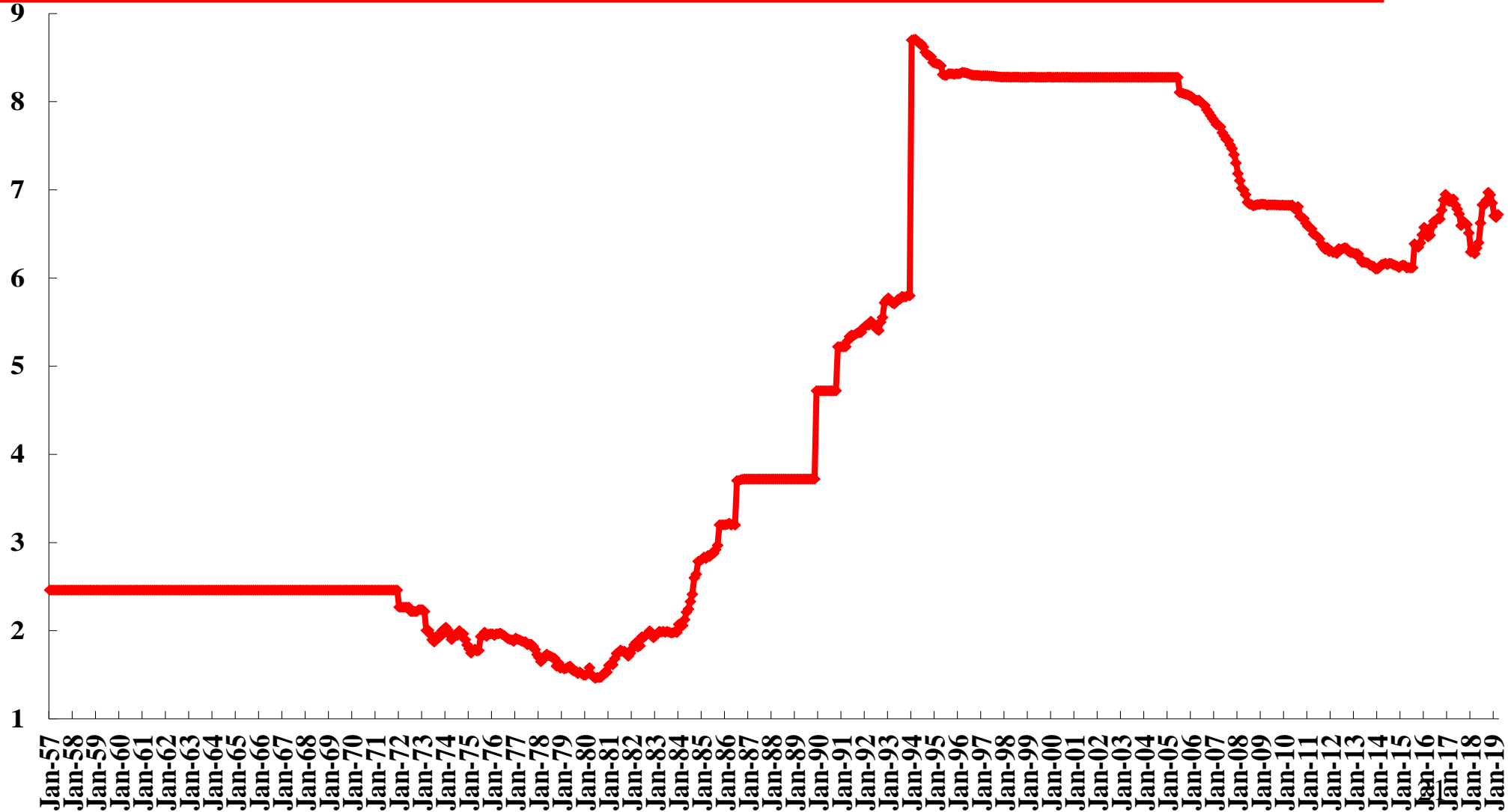
Economic Reform and Opening to the World: Export Promotion

- ◆ The promotion of exports and the attraction of cross-border direct investment required the setting of an internationally competitive exchange rate for the Renminbi, the Chinese currency. From the early 1950s to late 1971, the Renminbi exchange rate stood at a constant 2.46 Yuan per US\$ (see the following chart).
- ◆ During the period 1971-1978, the Renminbi exchange rate actually appreciated, reaching its highest level vis-a-vis the US\$ of 1.46 Yuan in 1980, partially driven by capital inflows. Then China began to undertake a series of explicit or implicit devaluations of the Renminbi, which reached 8.7 Yuan per US\$ at the beginning of 1994, when China unified its multiple exchange rates and adopted current-account convertibility.
- ◆ The Renminbi then appreciated slightly to 8.3 Yuan per US\$ until the East Asian currency crisis of 1997-1998, during which the Renminbi exchange rate held steady and remained unchanged with respect to the US\$ even as all of the other East Asian currencies with the exception of the Hong Kong Dollar and the Japanese Yen underwent significant devaluations.

Economic Reform and Opening to the World: Export Promotion

- ◆ Then beginning in mid-2005, because of China's large and growing current account surplus, the Renminbi began to appreciate significantly. However, this appreciation came to a halt in late 2008 because of the global financial crisis triggered by the collapse of Lehman Brothers in the United States and did not resume until 2010. Since then, the Renminbi exchange rate has fluctuated within a relatively narrow band between 6 and 7 Yuan per US\$.
- ◆ The Renminbi no longer follows the US\$ but appears to be following the value of a trade-weighted basket of the currencies of its major trading-partner countries, in effect, keeping its exchange rate approximately constant vis-a-vis the average trading-partner country, and maintaining the average purchasing-power of the Renminbi abroad.

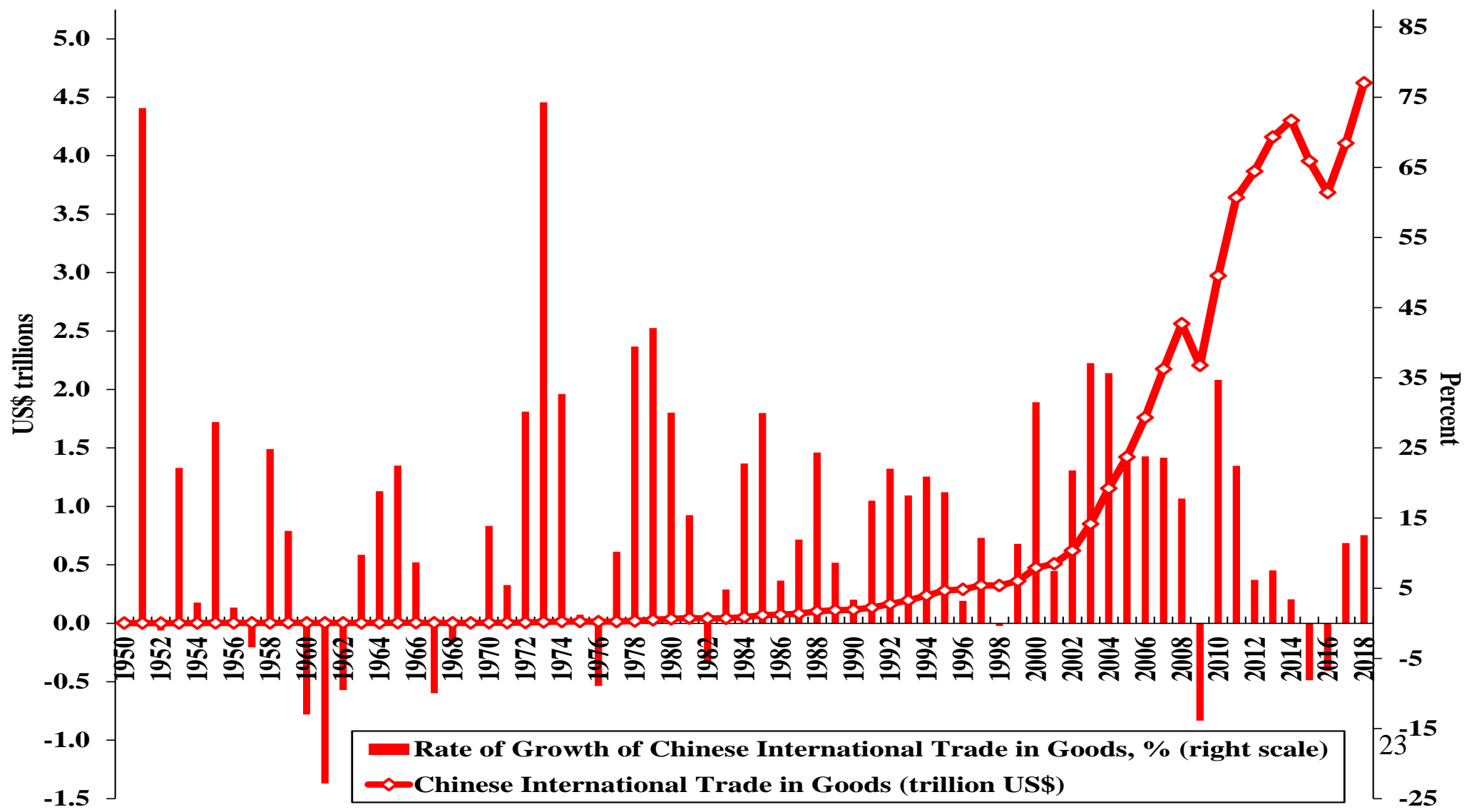
Nominal Exchange Rate of the Renminbi Since 1957, Yuan/US\$, End of Month



Economic Reform and Opening to the World: Export Promotion

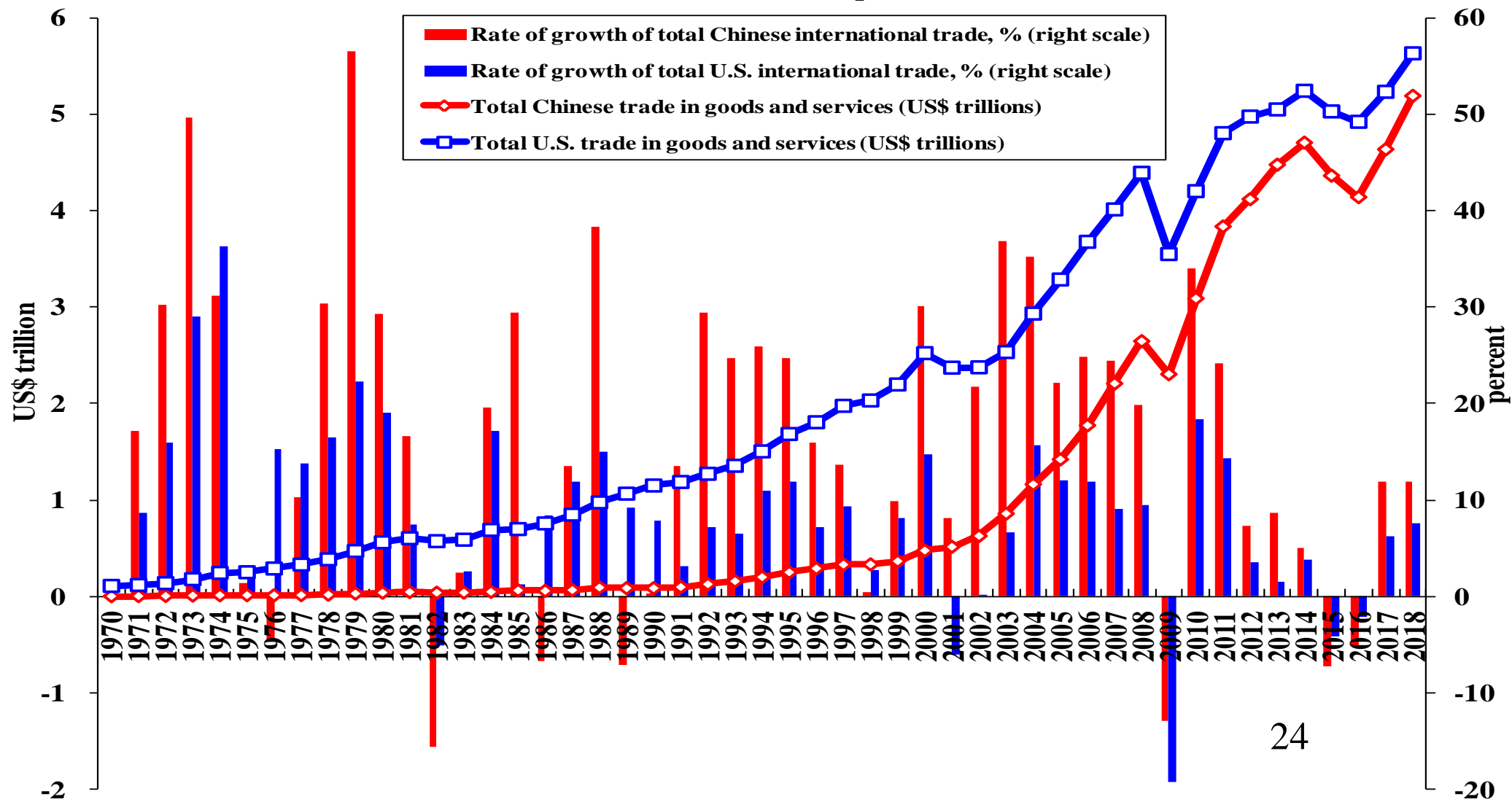
- ◆ In addition to setting a competitive exchange rate and making the Renminbi current-account convertible, China also applied to join the World Trade Organisation (WTO) as part of its export promotion strategy. It finally acceded to the WTO in 2001, after prolonged negotiations with the U.S. and other countries.
- ◆ The growth of Chinese international trade since 1978, and especially after its accession to the WTO in 2001, was in great contrast to what happened in the pre-reform period (see the following chart). Since 1978, Chinese international trade grew almost every year until very recently, except in 1982, 1998 (the East Asian currency crisis), and 2009 (the global financial crisis). In particular, it grew by leaps and bounds since its accession to the WTO in 2001. China has become the second largest trading nation in goods and services combined in the world, just after the U.S. and the largest trading nation in terms of goods only.
- ◆ The rate of growth of Chinese international trade has slowed down significantly in the past few years and a tariff war has broken out between China and the U.S. in 2018 and has yet to be ended.

Chinese International Trade in Goods and Its Annual Rate of Growth (US\$ trillion and %)



International Trade & Its Rate of Growth: A Comparison of China and the U.S. since 1970

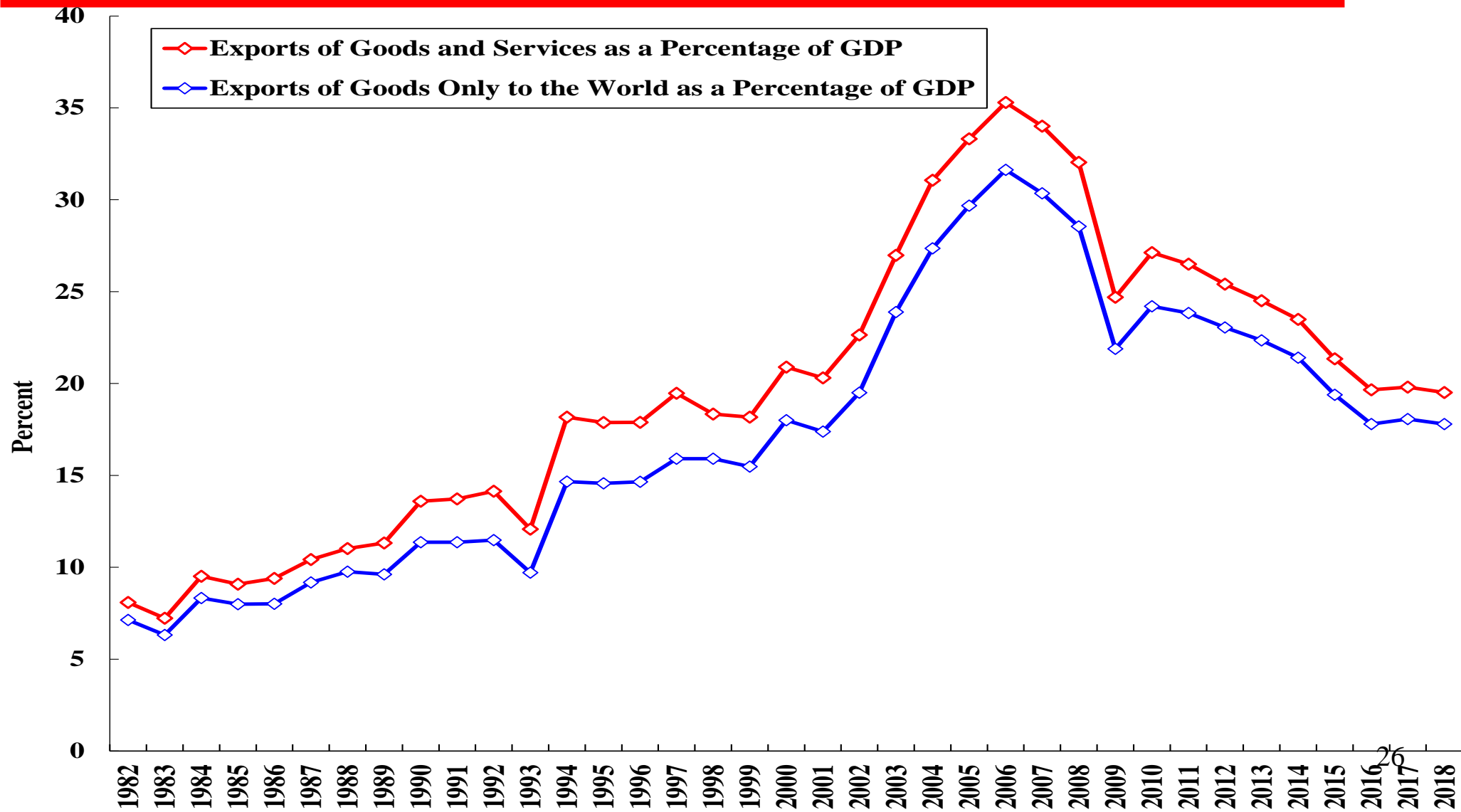
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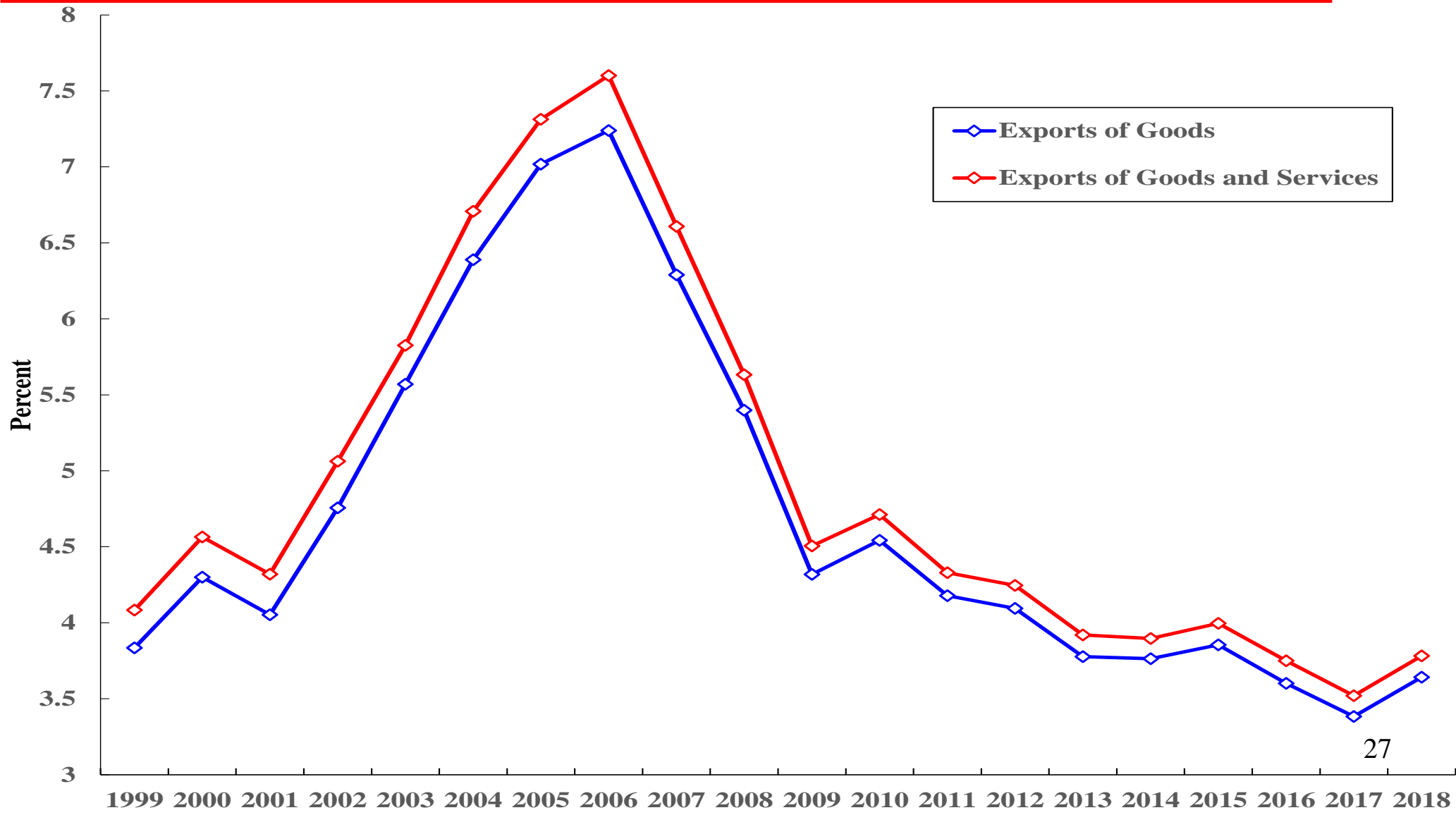
Economic Reform and Opening to the World

- ◆ Moreover, over the past ten years, Chinese dependence on exports has been declining. The share of exports of goods in Chinese GDP has fallen from a peak of 35.3% in 2006 to 19.5% in 2018. The share of exports of goods to the U.S. in Chinese GDP has also fallen by half, from a peak of 7.2% in 2006 to 3.6% in 2018. (See the following charts.)
- ◆ During this same period, the growth of Chinese exports to the world and to the U.S. has also slowed significantly. Chinese exports to the world grew at an average annual rate of 23.0% in the decade 1998-2008, but slowed to only 5.9% in the following decade, 2008-2018. Similarly, exports to the U.S. grew at 21.8% per annum in the decade 1998-2008, but slowed to less than 6.6% per annum in the most recent decade. Exports is no longer the engine of Chinese economic growth.

Chinese Exports of Goods and Services and Goods Only as a Percent of Chinese GDP



Chinese Exports of Goods and Services and Goods to the U.S. as Percent of Chinese GDP



Additional Economic Development Policies: Maintenance of Macroeconomic Stability

- ◆ Domestic macroeconomic stability is crucial for households, enterprises and governments to think and plan long-term. Without long-term planning, there will be no investment, public or private, and in particular, there will be no investment in the needed basic infrastructure.
- ◆ Moreover, opening of the domestic economy in the absence of a minimum degree of macroeconomic stability is risky because it will lead to massive capital flight, significant devaluation and even more inflation.
- ◆ The control of inflation is thus an integral part of maintaining macroeconomic stability. It is essential for the stabilisation of the exchange rate, which in turn makes it possible for the economic development policy of export promotion to be successfully implemented.
- ◆ Furthermore, a high rate of inflation often makes the income distribution more unequal. Inflation favours net borrowers and penalises net savers. Low-income individuals and retired individuals are also the least able to cope with the effects of inflation.

Additional Economic Development Policies:

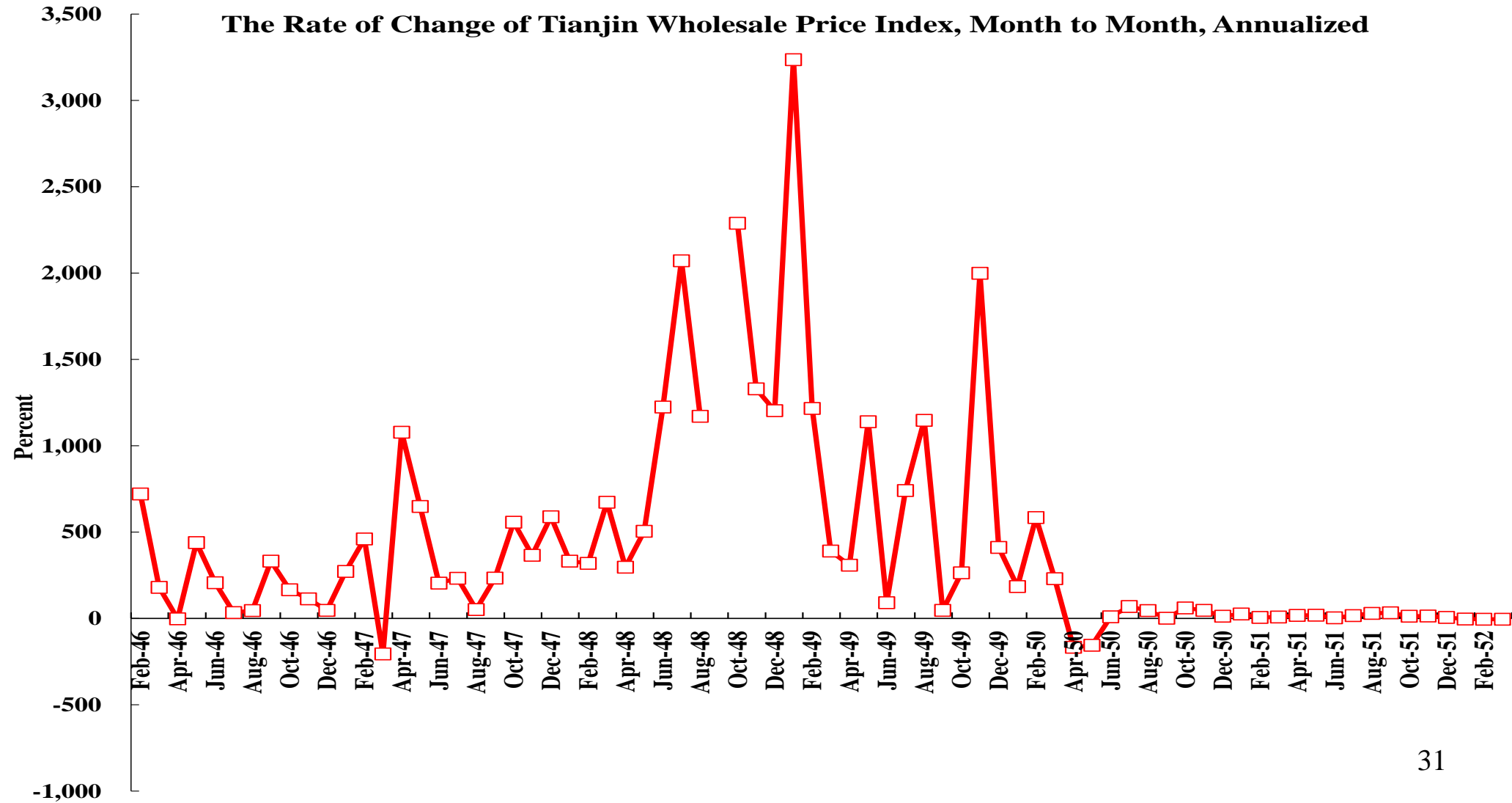
Maintenance of Macroeconomic Stability

- ◆ In 1947, there was hyper-inflation in China. The late Professor Sho-Chieh TSIANG proposed the issuance of inflation-indexed retail bonds, with both the principal and interest tied to the rate of inflation, as a way to tame it. The key is that if the commitment of the government to indexing is perceived to be credible, it can change inflationary expectations. Regrettably, this proposal was not adopted by the Nationalist government at the time.
- ◆ But when the Chinese Communists came to power in 1949, they adopted and implemented the indexing proposal, launching a kind of bank deposit the principal and interest of which were indexed to the rates of change in the prices of a (weighted) basket of five goods—including rice, oil, salt and cotton cloth. These indexed bank deposits helped bring down the rate of inflation on the Mainland very quickly.

Additional Economic Development Policies: Maintenance of Macroeconomic Stability

- ◆ In January 1949, the rate of inflation on the Mainland was running at an annual rate of more than 3,000 percent! By June 1950, the rate of inflation fell to only 10 percent. By 1952, the price index began falling in absolute terms at which point the Communist government modified the rate of interest formula so that while it would go up with the rate of inflation it would not go down when inflation turned negative. (see the following chart.)
- ◆ Nationwide price indices were not available for China during this period. The chart shows the wholesale price index of the City of Tianjin, compiled by Nankai University, which was broadly representative of the rates of inflation in other urban areas in Mainland China at the time.
- ◆ Inflation was also very high in Taiwan in 1949-1950, it was also brought down relatively quickly.

The Monthly Rate of Inflation on the Mainland, 1946-52 (Tianjin Wholesale PI)



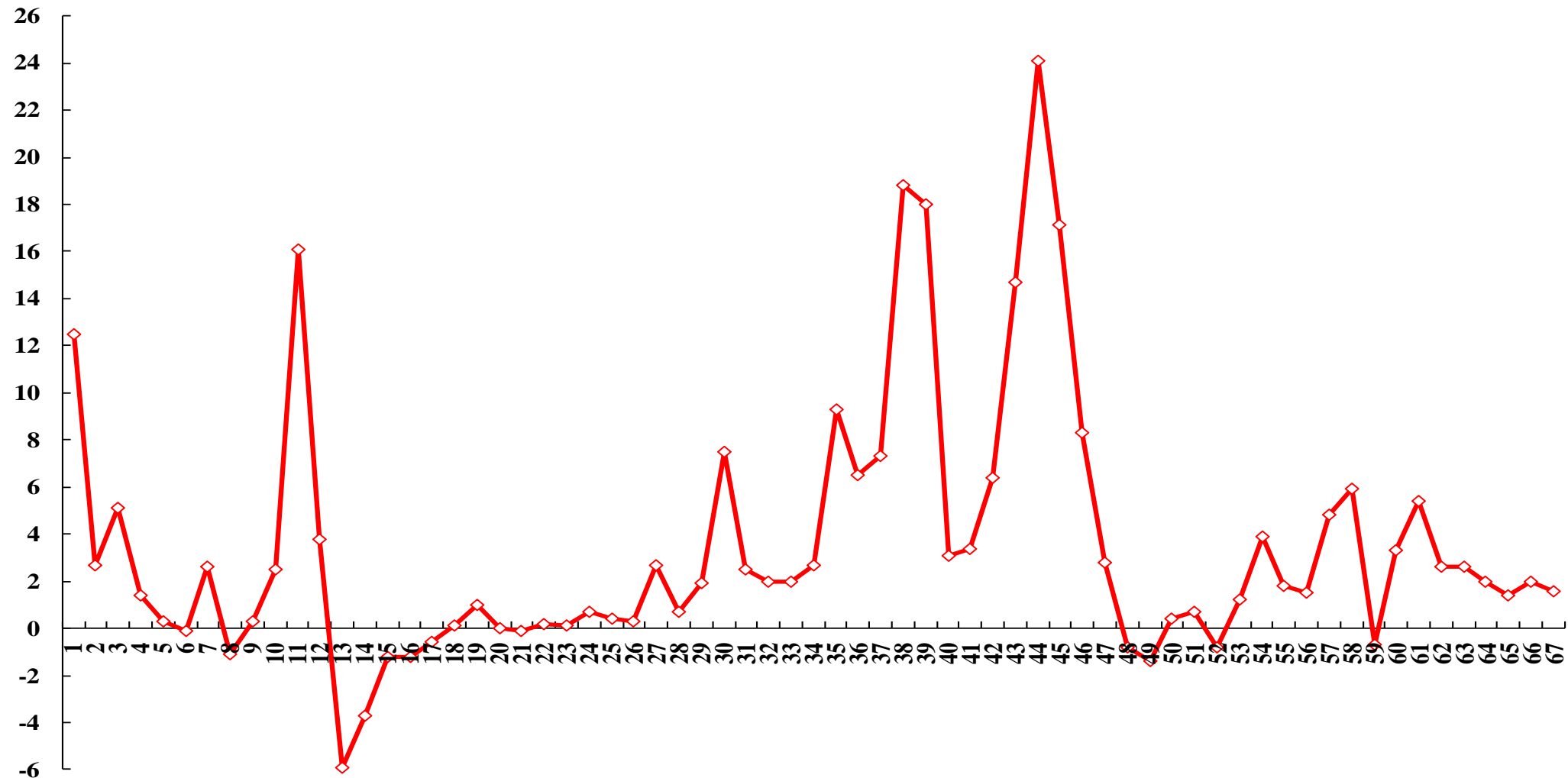
Additional Economic Development Policies:

Maintenance of Macroeconomic Stability

- ◆ Indexed bank deposits were introduced again on the Mainland in September 1988 in response to widespread panic buying and hoarding by the public because of its fear of inflation. They were effective in changing the inflationary expectations.
- ◆ The indexed bank deposits were once again introduced in 1993 when the rate of inflation rose again.
- ◆ At this time, the commercial banks were still owned and operated by the government.

The Rate of Inflation in Mainland China, 1951-2016 (Consumer Price Index), percent p. a.

The Rate of Inflation of Mainland China, 1951-2017 (Consumer Price Indices), percent per annum



Additional Economic Development Policies: Continuity of Governance

- ◆ One common feature of the early development stages of the East Asian economies is that they are all characterised by one-party rule, beginning with the Liberal Democratic Party in Japan, the British Colonial Government in Hong Kong, the Kuomintang (Nationalist Party) in Taiwan, President PARK Chung-Hee in South Korea, Prime Minister LEE Kuan Yew of Singapore, and then China and Vietnam, just to name a few.
- ◆ The advantages of one-party rule are: (1) It is possible to plan long-term, as there is no need to settle for only short-term outcomes (basic infrastructure, so critical in the early development stage, will only be provided by a government with a long-term perspective); (2) There is consistency and continuity in economic policy; and (3) The households and enterprises can share a common long-term vision and have common expectations about the future.
- ◆ Of course, this is not to say that there are no disadvantages to one-party rule. Many countries governed by dictatorships are among the poorest in the world. But when one-party rule works well, it is more efficient than any other system.

Additional Economic Development Policies

- ◆ Other reforms, such as the introduction of a value-added taxation system, the establishment of a commercial banking system, and the introduction of a stock market, were also initiated and implemented during this period.

Economic Reform and Opening to the World: Crossing the River by Feeling the Stones

- ◆ However, it would be wrong to think that there was an overall comprehensive blueprint for Chinese economic reform from the very beginning. As Mr. Deng Xiaoping, the late Chinese paramount leader, famously said, the process of Chinese economic reform was like “crossing the river by feeling the stones underneath (摸着石头过河)”. There was a great deal of uncertainty as to the right path. It was also not at all clear what would be found on the other side of the river. What was clear was that staying on the then existing side was not a viable option.
- ◆ In Chinese economic reform, trial and error was the norm—there were many pilot experiments; pragmatism was the guide; and adaptability would be widely practiced.

Economic Reform at Present

- ◆ The Chinese economy today faced a number of important challenges.
- ◆ First, there is excess production capacity in almost every major traditional industry—steel, cement, plate glass, ship-building, solar panels, you name it, and excess residential housing units in almost every city with the possible exception of the three or four first-tier cities. There must be supply-side structural reform to reduce the excess capacity and to re-train and re-employ the affected workers.
- ◆ Second, the forty years of rapid economic development has resulted in serious environmental degradation in the quality of air, soil and water.
- ◆ Third, income disparity has increased dramatically. China today has reportedly the highest number of known US\$ billionaires in the world, more than 600.
- ◆ Fourth, the working-age population has begun to decline and the Chinese population has begun to age.
- ◆ All of these are in addition to the on-going anti-corruption campaign, which is critical for letting the market play the decisive role.

Economic Reform at Present

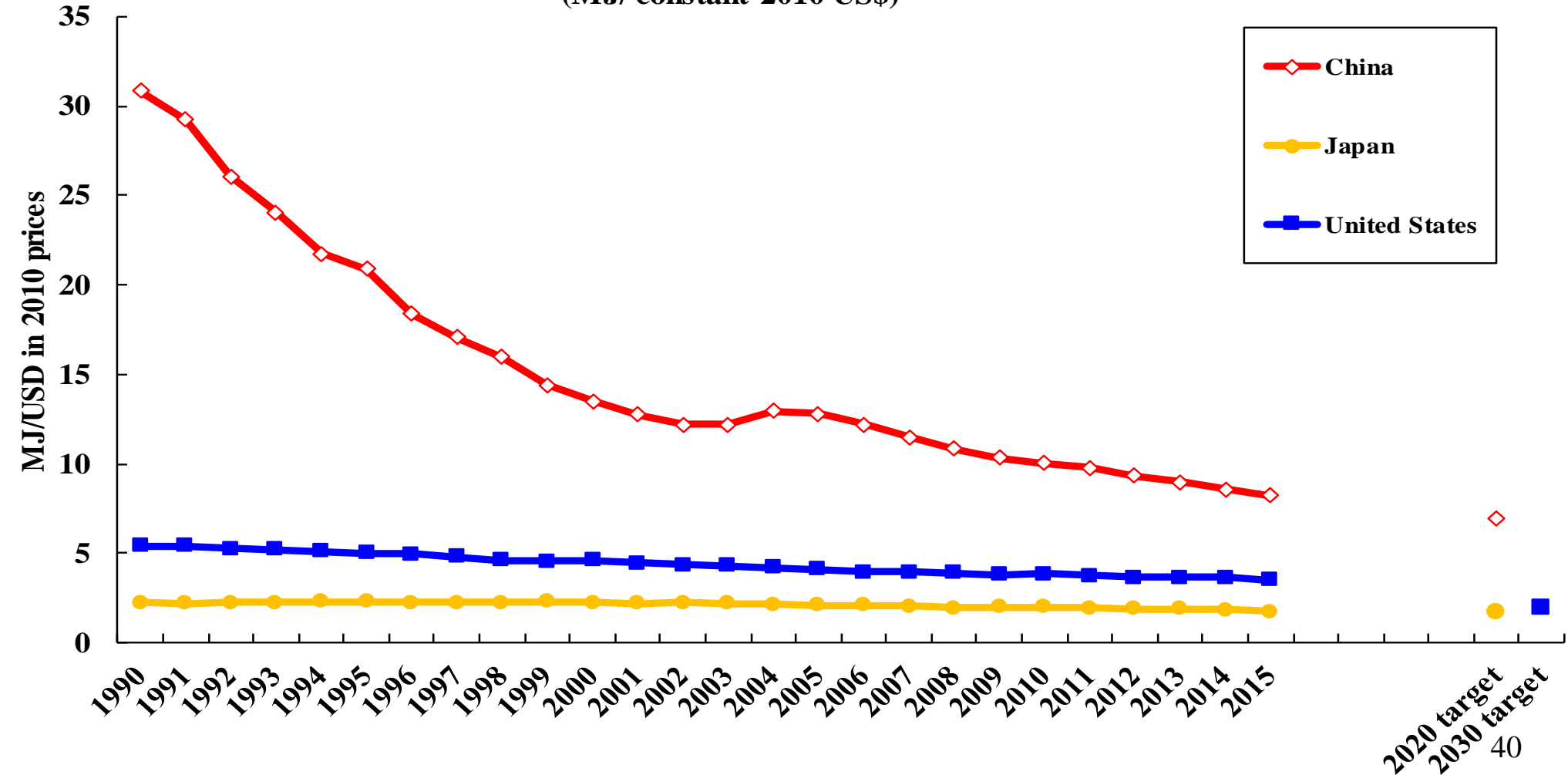
- ◆ The excess production capacities in the different industries are being gradually reduced.
- ◆ The “one-child” policy has been replaced by a “two-child” policy a few years ago. In the long run it is probably best to aim at a net reproduction rate of one, that is, on average, each couple will have two children. This will result in a more or less constant level of population in steady state. However, in order to achieve a net reproduction rate of one, it will be necessary to have a “more than two child” policy. One possibility is to abolish restrictions on the number of children altogether. It is rare for any couple to want three or more children these days, especially in the cities.

Economic Reform at Present: Increase Energy Efficiency and Reduce Pollution

- ◆ One measure of energy efficiency is the energy used per unit real GDP. In the following chart we compare the energy/GDP ratio of China, Japan and the United States in terms of million joules per unit real GDP in 2010 U.S. Dollars. (The Joule is a unit of energy and is equal to the more familiar 0.000948 BTU (British Thermal Unit)). It is clear that China has been improving its energy efficiency over time, which implies that overall carbon emission per unit real GDP is being reduced. However, it still has significant room to improve.
- ◆ Another measure of the quality of economic growth is the quantity of PM 2.5 particles in the air. Here we can also see from the data on Beijing the gradual improvement. As the quality of air has become a mandatory key performance indicator in the Thirteenth Five-Year Plan, it will likely continue to improve over time.

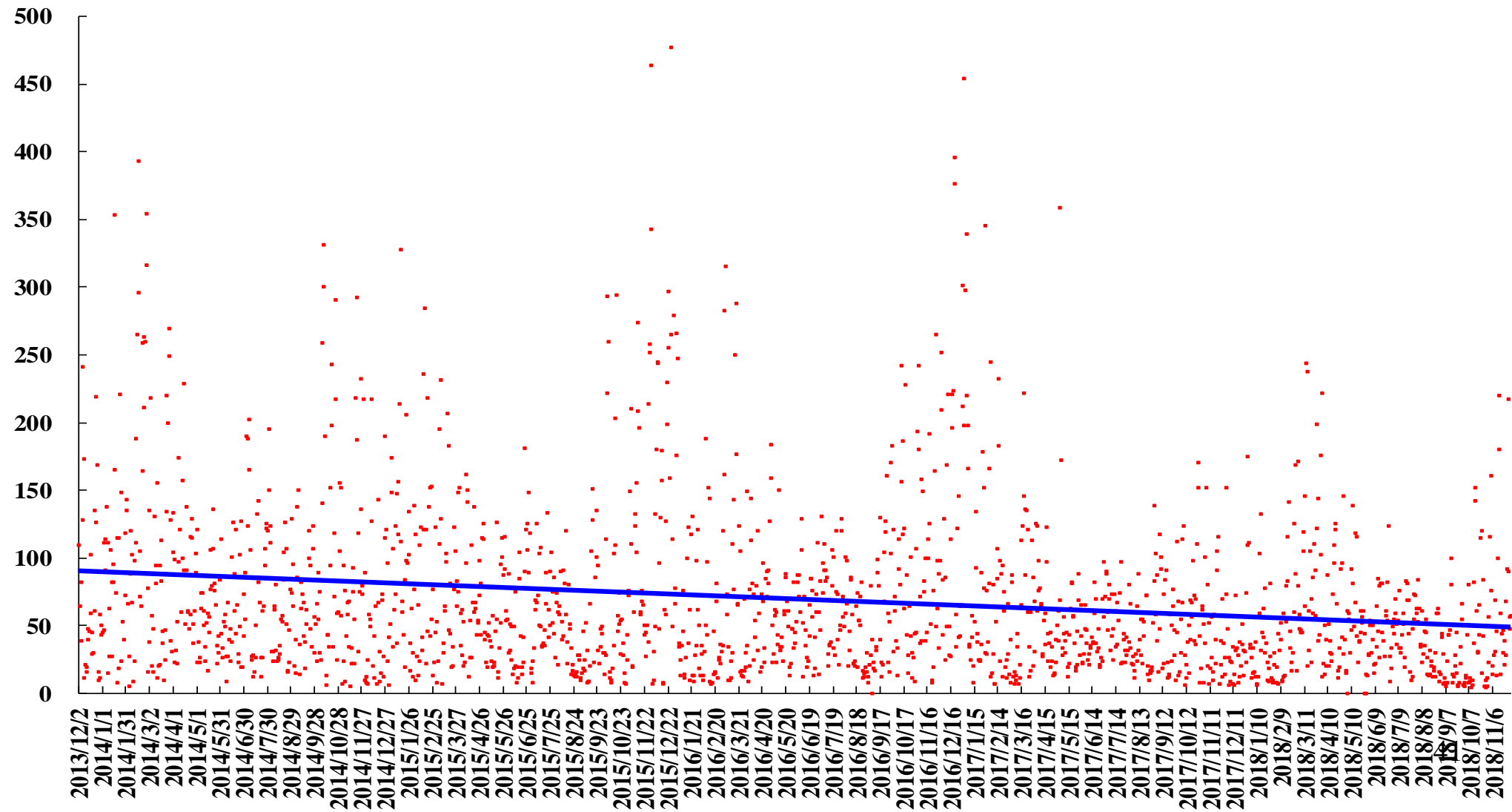
Final Energy Consumption/GDP Ratio for China, Japan and the U.S. (Million Joules/2010 US\$)

Final Energy Consumption / GDP Ratio for the U.S., Japan and China
(MJ/ constant 2010 US\$)



The Incidence of PM2.5 in Beijing: Daily Data from 2013M2 to 2018M11

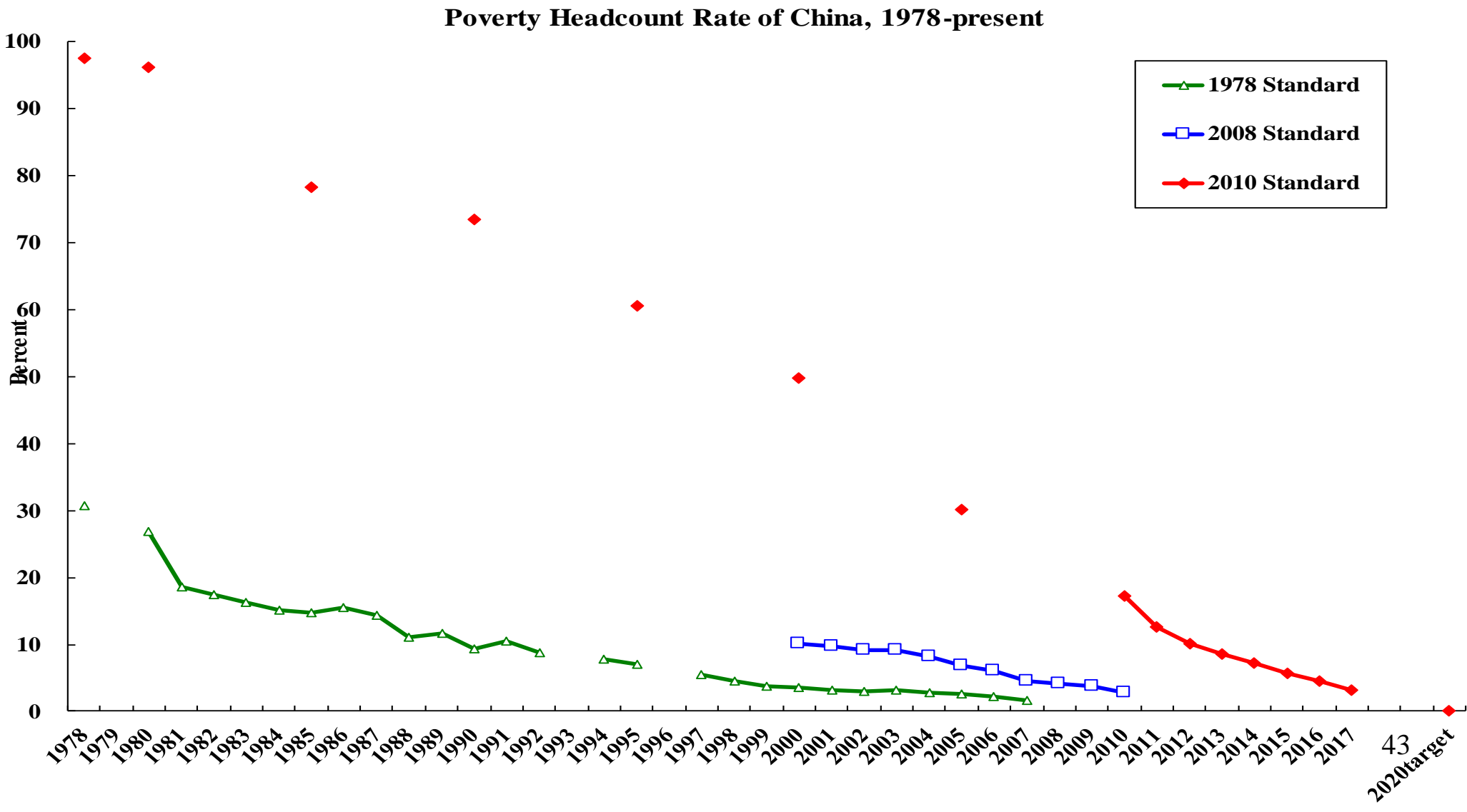
The Incidence of PM2.5 in Beijing



Economic Reform at Present: Share Prosperity

- ◆ The poverty headcount rate of China has been declining continuously since the economic reform began in 1978. According to the 2010 standard of poverty, over 95% of the Chinese population was below the poverty line in 1978. Today that share would be below 5%. It is expected that by 2020, poverty according to the 2010 standard will have been completely eradicated.

Poverty Headcount Rate of China, 1978-present



Economic Reform for the Future

- ◆ There are three major directions:
- ◆ Continuing to strengthen the role of the market in the allocation of resources;
- ◆ Enhancing the quality of growth and de-emphasising the quantity of growth;
- ◆ Opening the economy further to international trade and cross-border direct and portfolio investment, both inbound and outbound. This is especially important because China cannot afford to become isolated in the world, given the ongoing trade war and economic and technological competition with the U.S.

Economic Reform for the Future: Letting the Market Play the Decisive Role

- ◆ Implementation of the “rule of law”.
- ◆ Improving the social safety net.
- ◆ Reform of the income taxation system.
- ◆ Reform of the pension system.

Letting the Market Play the Decisive Role: The Goods and Services Market

- ◆ The efficiency of the market system depends on both free entry and effective competition. Free entry requires openness and effective competition requires a level playing field for all enterprises. It is the responsibility of the government to ensure that there is sufficient effective competition in every market. This means the enforcement of anti-monopoly and anti-unfair competition laws, which are already on the Chinese law books. Local protectionism should be actively forbidden. A level playing field can be achieved by the elimination of subsidies and implementing national treatment for all enterprises.

Letting the Market Play the Decisive Role: The Goods and Services Market

- ◆ It is also possible for the government to be more pro-active in creating the appropriate infrastructure. A concrete example is the national oil and gas pipeline system that China is in the process of creating out of the existing pipelines of the three major Chinese oil companies--China National Petroleum Corporation (CNPC), China Petroleum and Chemical Corporation (Sinopec), and China National Offshore Oil Corporation (CNOOC)--that will serve all users on an equal basis. While the pipeline network itself will be a monopoly, and will have to be regulated as a public utility, its creation should minimise wasteful duplications and lower transportation and transaction costs to all users, thereby greatly reducing the costs of entry into the oil and gas industry by both upstream and downstream firms.
- ◆ For example, an independent shale-oil explorer and producer can sell its oil to any refinery or any petrochemical processing plant in the country through the pipeline network. Thus, exploration, production, refining, petrochemical manufacturing and distribution can all become more competitive and many smaller enterprises can enter the oil and gas industry.

Letting the Market Play the Decisive Role: The Goods and Services Market

- ◆ The same effects are also true of the national electricity grid and of a network of wireless communication base stations (for example, for 5G). In a broader sense, a national network of public highways also serves the same purpose of facilitating market competition and reducing local monopoly power.
- ◆ National standardisation and quality assurance and certification will also enhance competition in the goods and services markets.

Letting the Market Play the Decisive Role: The Capital Market

- ◆ Increase equity financing to replace debt financing and thus reduce the overall leverage in the economy.
- ◆ Mandate cash dividends for profitable state-owned enterprises to encourage investors to hold equity long-term. This should also decrease corporate leverage, improve governance, decrease wasteful investment, enhance government revenue as a major shareholder, reduce volatility of the stock market and provide automatic market support for the stocks. This should also put pressure on privately-owned enterprises to pay cash dividends to their shareholders. The payment of cash dividends will also make it very difficult to falsify accounts credibly.
- ◆ This should also provide Chinese households reliable and safe investment instruments.

Economic Reform for the Future: Enhancing the Quality of Growth

- ◆ Survival is no longer a problem for the Chinese people. By 2020, absolute poverty according to current standards would have been completely eliminated. Altogether an estimated 740 million Chinese people have been lifted out of poverty since 1978.
- ◆ The focus is on the preservation, protection and restoration of the environment, on blue sky, green mountains and clear waters, and other public goods such as education, health care and elderly care.
- ◆ Chinese people are also taking much more leisure—the average number of work hours has been declining continuously and life expectancy has increased significantly. Conventionally measured GDP cannot reflect these improvements in welfare.

Economic Reform for the Future: Opening the Economy Further

- ◆ Reduction of tariff and non-tariff barriers to international trade in goods and services.
- ◆ Facilitation of cross-border direct and portfolio investment, both inbound and outbound.
- ◆ Further and fuller opening-up is also about the introduction and adoption of new institutions, new processes, new systems and new ways of doing things in China.
- ◆ “The Three Zeros Strategy: zero tariffs, zero barriers and zero subsidies”.
- ◆ Internationalisation of the Renminbi by maintaining a stable exchange rate on average.

Facilitation of Cross-Border Direct Investment, Both Inbound and Outbound

- ◆ A new foreign investment law has been passed by the Chinese National People's Congress. Market access by foreign direct investors will be considerably improved, with a substantially shortened “negative” list, the elimination of the requirement of a fifty-fifty Chinese joint-venture partner, and national treatment for all enterprises irrespective of ownership in the open sectors.

Is “Reform without Losers” Still Possible?

- ◆ In 1978, China was extremely poor, and there were no significant vested interests. In any case, the vested interests were adequately protected, for example, by the dual-track system.
- ◆ Today, there are many significant vested interests and reform without losers has become much more difficult, if not impossible. China is not unlike the developed economies, in which economic globalisation and innovation create both winners and losers. The free market on its own cannot compensate the losers.
- ◆ Chronically uncompensated losers will eventually turn against the establishment in frustration and anger. This is what has happened in the U.S. and in Western Europe (the U.K., France, Germany, Italy, etc.).
- ◆ In China, income disparity has also increased significantly. However, most Chinese people still remember how bad things were in 1978, and realise how much improvement there has been. But in another decade or two, another generation with no memory of the hard times may ⁵³ decide to vent their anger and frustration more openly.

Concluding Remarks

- ◆ The development experiences of East Asian economies show that an open global economy can provide the environment for developing economies to grow and prosper through international trade.
- ◆ The East Asian experiences also show that domestic macroeconomic stability is important. Without macroeconomic stability, no one will think or plan long-term. Investment will dry up. Opening of the domestic economy in the absence of a minimum degree of macroeconomic stability is risky because it will lead to massive capital flight, significant devaluation and even more inflation.
- ◆ A low rate of inflation is also essential to the maintenance of a relatively stable exchange rate and the success of an export promotion policy.

Concluding Remarks

- ◆ The development experiences of East Asian economies also show that a high domestic savings rate, the existence of surplus labour, and investment in intangible capital provide the necessary domestic conditions for an economy to grow and prosper.
- ◆ However, a source of aggregate demand is also needed in order to be able to make full use of the domestic resources. Exports can provide the initial growth in aggregate demand.
- ◆ Today, no one argues seriously for import substitution as the sole policy to promote economic development. One important reason is the lack of sufficient domestic demand when the GDP per capita is still low. Another important reason is that what needs to be imported can only be produced domestically at a very high cost, even if it is possible to do so at all. Most economies are better off exporting other things that they can more easily make themselves, capitalising on their comparative advantages.